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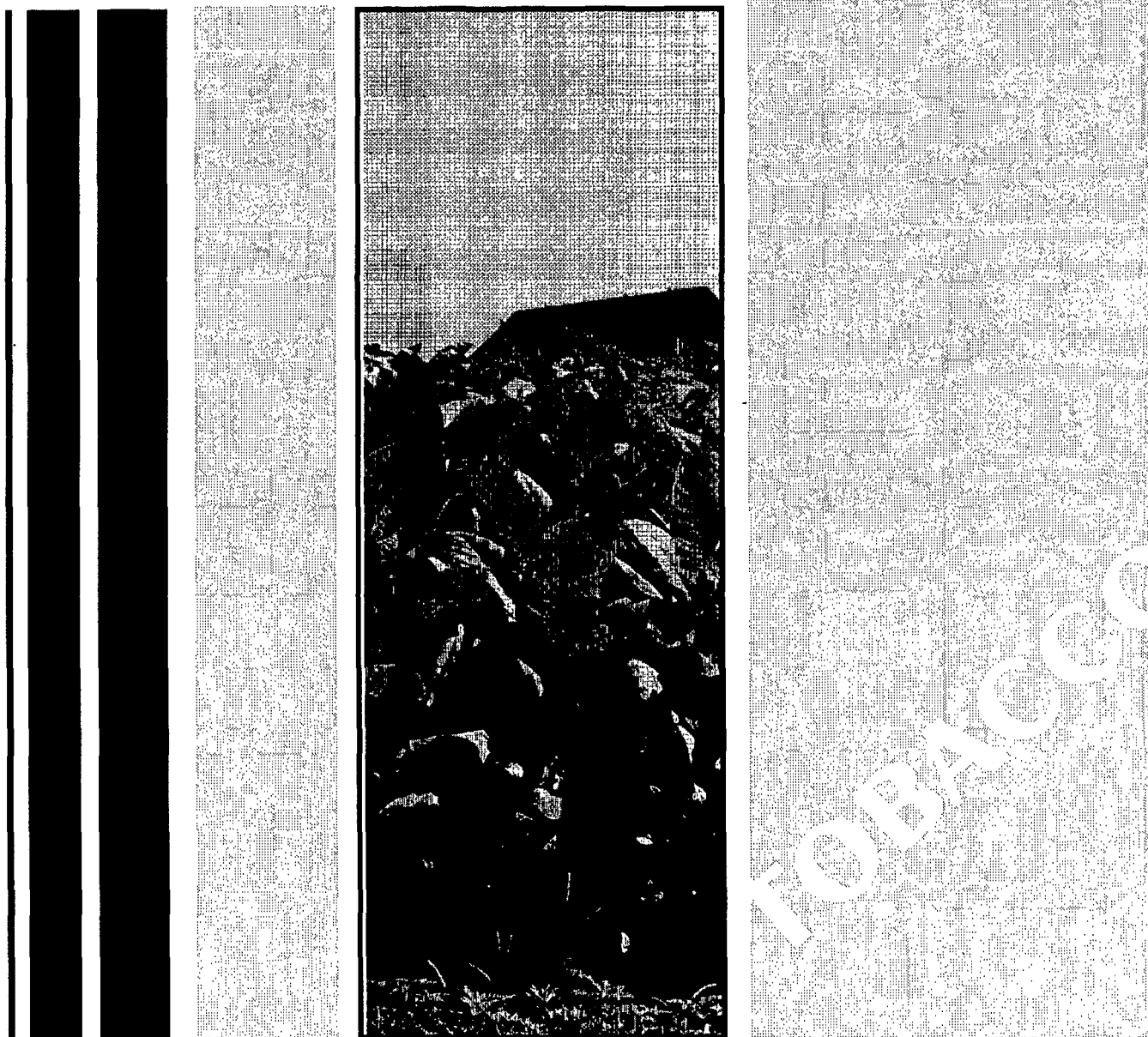
Agricultural  
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Number 709

*An Economic Research Service Report*

# Tobacco

## Background for 1995 Farm Legislation

Verner N. Grise



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## The Tobacco Briefing Room

### Tobacco Price Support: An Overview of the Program 1/

Jasper Womach  
Specialist in Agricultural Policy  
Environment and Natural Resources Policy Division  
Congressional Research Service

#### Summary

Over 93% of U.S. tobacco production is flue-cured and burley (both being cigarette tobacco types). These crops are particularly important to the agriculture of North Carolina (where flue-cured is grown) and Kentucky (where burley is grown). Together, these two states produce 65% of the total U.S. tobacco crop. The federal tobacco price support program is designed to support and stabilize prices for farmers. It operates through a combination of mandatory marketing quotas and nonrecourse loans. Marketing quotas limit the amount of tobacco each farmer can sell, which indirectly raises market prices. The loan program establishes guaranteed minimum prices. The law requires that the loan program operate at no net cost to the federal government. Apart from year-to-year budget impacts, no-net-cost provisions of the law are intended to assure that all loan principal plus interest will be recovered.

#### Industry Profile

World production of tobacco is estimated at about 14.0 billion pounds for 1995. Production data are collected for over 100 countries. However, about 80% of world tobacco is produced in the following eleven countries: China (5,180 mil. lbs.), United States (1,323 mil. lbs.), India (1,156 mil. lbs.), Brazil (877 mil. lbs.), Turkey (464 mil. lbs.), Zimbabwe (463 mil. lbs.), Indonesia (375 mil. lbs.), Italy (292 mil. lbs.), Greece (291 mil. lbs.), Malawi (240 mil. lbs.) and Pakistan (235 mil. lbs.).2/

Some 124,000 U.S. farms grew about 1,323 million pounds of tobacco on about 652,000 acres in 1995. The estimated farm value of the 1995 crop is \$2.8 billion. Major U.S. tobaccos are flue-cured (produced primarily in North Carolina) and burley (produced primarily in Kentucky), which are both cigarette tobaccos. Other types of tobacco are used for cigars, chewing, and snuff.

Tobacco is grown in 16 states; North Carolina and Kentucky originate 65% of total production. Four other states (Tennessee, Virginia, South Carolina, and Georgia) produce another 26%. The high per acre value of tobacco sales (averaging \$3,968 in 1995) makes it critical to the income of the growers and important to the economies of the major producing states. For North Carolina in 1995, tobacco constituted 13% of the value of all farm commodities (crops and livestock); for Kentucky, tobacco accounted for 20% of the value of all commodities.

The United States is the world's largest exporter of manufactured tobacco products (cigarettes) and about equal to Brazil as a top exporter of unmanufactured tobacco leaf. During 1995, the United States exported 613 million pounds (farm sales weight) of leaf tobacco, valued at \$1.4 billion. Major U.S. leaf markets were Japan, Germany, the Netherlands, and Turkey. The value of U.S. manufactured tobacco product exports was \$5.2 billion. The largest export cigarette destinations were Belgium-Luxembourg and Japan.

In 1995, U.S. manufacturers produced an estimated 755 billion cigarettes (about 32% were exported). American blend cigarettes are a combination of flue-cured, burley, and oriental tobaccos. All of the oriental tobacco is imported (from primarily Turkey). Beginning in 1994, cigarette manufacturers were required to use at least 75% U.S.-grown tobacco in cigarettes. Consequently, tobacco imports dropped substantially below recent levels. Legislation implementing new international trade rules (Uruguay Round Agreements Act, P.L. 103-465) have replaced the domestic requirement with a tariff rate quota, which will achieve the same goal but by means of a high tariff.

Consumption of cigarettes has declined nearly 25% in the United States since 1981, from 640 billion to an estimated 488 billion in 1995. However, spending for tobacco products has increased as a result of price and tax increases. In 1995, consumers spent about \$49 billion on tobacco products (93% for cigarettes).

Tobacco products are subject to federal excise taxes. In addition, all states and some local governments impose excise taxes. Nationally, cigarette excise taxes now average 56.7 cents a pack, with 24 cents being federal. Excise tax collections during 1995 totaled an estimated \$13 billion (federal, \$5.9 billion; state, \$6.9 billion; local, \$182 million).

### **The Price Support Program**

Small changes in the supply of tobacco can cause disproportionately large changes in wholesale prices (because consumption is relatively insensitive to price). Cyclical swings in tobacco prices, and the associated farm income crises, led to grower efforts to voluntarily control production in the early part of this century. In some cases, violence was used against uncooperative growers. But the nongovernmental efforts failed. During the Great Depression of the 1930s, the federal government adopted farm income and commodity price support policies that included mandatory supply controls for several major crops, including tobacco.

The tobacco price support program exists only for the economic benefit of farmers. It was created for the purpose of supporting the income and stabilizing the price of tobacco received by farmers. By law, the choice of whether or not federal support will be provided is determined by growers in a referendum held every three years.

When producers approve federal price support for tobacco, they become subject to marketing quotas. Marketing quotas are a supply control mechanism that indirectly increases market prices. At the same time, the federal government is required to guarantee prices at least as high as the level specified in the law.

### **Legislative Authority**

The first commodity price support legislation was the Agricultural Adjustment Act of 1933. Various problems with this and subsequent legislation ultimately led to adoption of the Agricultural Adjustment Act of 1938 (P.L. 75-430). This permanent law established a supply control and price support program for tobacco that, even as amended, remains very much the same today. The current legal authority and requirements for the federal tobacco program are contained in 7 U.S.C. 1311-1316 and 7 U.S.C. 1445.

### **Administering Agency**

Program administrative operations are carried out by the USDA's Farm Service Agency (FSA). Annual administrative costs are estimated at about \$16 million in FY1996 for tobacco price support operations. This cost covers primarily salaries for some headquarters personnel and staff time devoted to the tobacco program in about 600 county offices. Price support operations (nonrecourse loans) are financed by USDA's Commodity Credit Corporation (CCC). The CCC obtains needed money by borrowing from the U.S. Treasury.

### **Program Operation**

The federal tobacco price support program limits and stabilizes the quantity of tobacco produced and marketed by farmers. This is achieved through marketing quotas. In addition, minimum market prices are guaranteed to farmers through CCC nonrecourse loans.<sup>3/</sup>

**Marketing Quotas.** When farmers vote in favor of price supports, they are at the same time agreeing to accept government restrictions on the amount of tobacco they can market. The national marketing quota is the amount judged sufficient to meet domestic and export demand, but at a price above the government support price. Each farm's quota is assigned to the land. So, the right to produce and market a specified quantity of tobacco resides with the owner of the land. A farmer can only begin to grow tobacco by purchasing or renting land that has a quota. By limiting the supply of tobacco, the market price is increased. Total farm revenue is raised because consumption does not decline enough to offset the price increase. In this way, farm income is supposed to be supported through artificially high market prices, rather than through direct government payments. This differs from other commodity support programs that utilize direct payments, rather than marketing quotas, as the principal subsidy mechanism.

**Loans.** Marketing quotas are not always totally effective at supporting market prices, given the numerous variables that affect tobacco supply and demand. Consequently, federal support prices are guaranteed through the mechanism of nonrecourse loans available on each farmer's marketed crop. The loan price for each type of tobacco is announced each year by the Secretary of Agriculture, who uses the formula specified in the law to calculate loan levels. The national loan price on 1996 crop flue-cured tobacco is \$1.601 per pound; the burley loan price is \$1.737.

At the auction sale barn, each lot of tobacco goes to the highest bidder, unless that bid does not exceed the government's loan price. In such cases, the farmer is paid the loan price by a cooperative, with money borrowed from the CCC. The tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for CCC. The cooperative, acting as an agent for the CCC, later sells the tobacco, with the proceeds going to repay the loan plus interest.

**No-Net-Cost and Marketing Assessments.** Under the threat of legislative dissolution of the program by its opponents, Congress passed the No-Net-Cost Tobacco Program Act in 1982 (P.L. 97-218). This legislation imposes an assessment on every pound of tobacco marketed. The no-net-cost assessment on 1996 crop flue-cured is 1.199 cents per pound; the burley assessment will be announced later in the year (but last year was 0.275 cents per pound). Growers and buyers each pay a portion of the no-net-cost assessment. Beginning in 1994, imported tobacco also became subject to the no-net-cost assessment. The assessment funds (which could amount to about \$10 million in 1996) is deposited in an escrow account that is held to reimburse the government for any financial losses resulting from tobacco loan operations. Losses occur when a cooperative sells loan collateral tobacco at a price insufficient to cover the loan principal plus interest.

Tobacco, like other commodity price support programs, is subject to deficit reduction requirements enacted by the Omnibus Budget Reconciliation Acts of 1990 (P.L. 101-508) and 1993 (P.L. 103-66). A marketing assessment of 1% of the support price is collected on every pound of tobacco marketed. This assessment is equally divided also between producers and buyers. Importers began paying the full assessment in 1994. This deficit reduction assessment (with the revenue going toward deficit reduction and not the tobacco program) should generate about \$27 million in FY1996.

### Experience

Passage of the No-Net-Cost Tobacco Program Act made a significant change in federal price support policy. Shifting the financial burden for tobacco program losses from the federal government to growers encouraged a reduction in support prices (which was done by legislation in 1986). Initially, this stopped the decline in U.S. tobacco leaf exports. However, the growing competitiveness of foreign tobacco has continued to erode the U.S. share of export markets. Foreign tobacco even had captured 40% of the domestic cigarette manufacturing market when Congress enacted a domestic content requirement. This domestic content requirement took effect in 1994 and limited foreign tobacco to 25% of the U.S. market. Under new international trading rules the domestic content requirement is replaced with tariff rate quotas, which are less restrictive than previous domestic content requirements.

Finally, the no-net-cost rule has muted much of the criticism that taxpayers are subsidizing tobacco farmers. The budgetary impact of the tobacco loan program is determined primarily by loan outlays (new loans made) and loan recoveries (repayment of old loans). In any given year, new loan outlays may be more or less than recoveries from the repayment of old loans. In FY1996, the large net receipt of nearly \$536 million is the result of previously large loan outlays now being repaid compared to a modest level of new loans being made. Since tobacco is typically stored for extended periods, it can be several years before the loan inventory is sold. In all cases, the law requires that any losses of loan principal and interest be repaid from the no-net-cost account, which is funded from assessments on growers and buyers of leaf tobacco.

**Tobacco Loan Program Outlays and Recoveries, FY1994-FY1997**

Loan Program Operation	(in Millions of Dollars)			
	FY1994 Actual	FY1995 Actual	FY1996 Estimate	FY1997 Estimate
Loan and misc. outlays(-)	-851.4	-160.9	-156.9	-154.9
Loan and misc. recoveries(+)	+130.6	+425.4	+535.5	+230.8
Net loan outlays(-) or recoveries(+)	-720.8	+264.5	+381.7	136.3
Deficit reduction marketing assessment receipts(+)	+28.1	+33.7	+27.2	+29.7
Total net budgetary receipts(+) or expenditures (-)	-692.7	+298.2	+405.9	+105.7

**Source:** Data are compiled from U.S. Department of Agriculture, Commodity Credit Corporation, Commodity Estimates Book, FY 1997 Mid-Session Review. Washington, D.C. July 16, 1996. p. 160.

### Other USDA Tobacco Related Activities

In addition to the tobacco price support program, the USDA administers several other programs designed to assist tobacco farmers, facilitate marketing, and provide information to federal program managers and policy makers. It administers subsidized multi-peril crop insurance for tobacco (as well as for other crops), which cost about \$21

million in FY1995. Also, as with other crops, the Department collects, analyzes, and disseminates data on tobacco production, utilization, and prices, costing about \$1.5 million in FY1995. The Department is specifically prohibited from spending research funds on the production, processing or marketing of tobacco, and from promoting the sale or export of tobacco or tobacco products. These prohibitions are contained in the annual appropriation law.

### For More Information

- FSA each year issues an updated FSA Commodity Fact Sheet on the tobacco price support program (as well as other commodity programs), which includes eligibility information, program details, and historical data (call the FSA Legislative Liaison Staff at 202-720-3865).
- *Tobacco Situation and Outlook Report*, published by USDA's Economic Research Service, is a quarterly compendium of production, trade, demand, and other current and historical data, plus special analytical articles (call the Tobacco Situation Coordinator at 202-219-0890). ERS has also published *Tobacco: Background for 1995 Farm Legislation* (April 1995), available from the publications office (202-219-0515).
- Additional information on tobacco and other USDA price support programs is available from the Food and Agriculture Section of CRS.

1. This is one of a series of CRS short reports on federal farm commodity price support programs. Data in this report, unless otherwise specified, are from recent issues of *Tobacco Situation and Outlook Report*, published by the ERS. [Go Back](#)

2. U.S. Department of Agriculture, Foreign Agriculture Service. *Tobacco: World Markets and Trade*. Washington, D.C. December 1995. [Go Back](#)

3. The term nonrecourse means that no additional recourse is taken against a borrower beyond taking ownership of the collateral. The collateral is accepted as full settlement of the debt. [Go Back](#)

Contact: [thomasc@econ.ag.gov](mailto:thomasc@econ.ag.gov)

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**Tobacco: Background for 1995 Farm Legislation.** By Verner N. Grise. Commercial Agriculture Division, Economic Research Service, U.S. Department of Agriculture. Agricultural Economic Report No. 709.

## **Abstract**

U.S. tobacco production is likely to decline by the end of the 1990's. Accelerated antismoking activity, along with an increasing number of smoking restrictions and prohibitions and proposals to increase cigarette taxes, is weakening leaf demand. Also, ample world production at lower prices is hurting U.S. export prospects. Technological advances that permit production of an acceptable-quality cigarette with cheaper leaf are curtailing demand for U.S.-grown leaf. Furthermore, stagnant cigarette demand and trade barriers hold down U.S. export prospects, although the General Agreement on Tariffs and Trade should help soften declines in exports. This report provides an overview of the U.S. tobacco industry, reviews Federal tobacco programs, and examines issues and potential program changes.

**Keywords:** Tobacco, price supports, poundage quotas, exports, imports, costs, and returns

## **Foreword**

Congress will soon consider new farm legislation to replace the expiring Food, Agriculture, Conservation, and Trade Act of 1990. Although the tobacco program is under continuing legislation, a number of problems face the tobacco industry, and amendments to modify the tobacco program may be considered in the next farm bill debate. In preparation for these deliberations, the U.S. Department of Agriculture and other groups are studying previous legislation and current situations to see what lessons can be learned that are applicable to the 1990's and beyond. This report updates *Tobacco: Background for 1990 Farm Legislation* (AGES-89-48), by Verner N. Grise. It is one of a series of updated and new Economic Research Service background papers for farm legislation discussions. These reports summarize the experiences with various farm programs and the key characteristics of the commodities and the industries that produce them. For more information, see Additional Readings at the end of the text.

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## Summary

Production of U.S. tobacco is likely to decline by the end of the 1990's. Accelerated antismoking activity, together with an increasing number of smoking restrictions and prohibitions and proposals to increase cigarette taxes, is weakening leaf demand. This, together with ample world production at lower prices, is hurting U.S. export prospects.

A shift worldwide to cheaper cigarettes and technological advances that permit production of an acceptable-quality cigarette with cheaper leaf are holding down demand for U.S.-grown leaf. Furthermore, stagnant cigarette demand and trade barriers continue to hold down U.S. export prospects, although the General Agreement on Tariffs and Trade should help soften potential declines in exports.

Congress will soon consider new farm legislation to replace the expiring Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624). A number of problems face the tobacco industry and amendments to modify the tobacco program may be considered in the next farm bill debate. This report provides an overview of the U.S. tobacco industry, reviews Federal tobacco programs and their effects, and examines issues and potential program changes.

The tobacco program is authorized under permanent legislation and, unlike most commodity programs, it does not have to be rewritten every 4 or 5 years. However, a number of legislative changes have been made since the basic marketing quota provisions of the Agricultural Adjustment Act of 1938. Legislation enacted in 1986 and 1993 made substantial changes in the program. The 1986 law reduced flue-cured and burley price supports, changed the setting of quotas to a more market-oriented approach, and provided for orderly movement of surplus stocks into trade channels. The 1993 law limited use of foreign-grown leaf in U.S. cigarettes, by applying assessments on imports and penalizing noncompliance.

Despite the changes that have been made in the tobacco program, several major concerns persist. Issues that affect the industry concern:

- **Program rationale.** The rationale for a tobacco program that has any government involvement. Intensive efforts by health groups and some Congressional leaders to bring tobacco products under the jurisdiction of the Food and Drug Administration (FDA), growing antismoking efforts, and prohibitions and restrictions on smoking are jeopardizing U.S. tobacco support programs.
- **Price support levels.** The level of price support and the appropriateness of the current support formula, which has resulted in high U.S. tobacco prices.
- **Competitive relationships.** Continued concern about high U.S. tobacco prices and manufacturers' desire to use cheaper imported leaf and sluggish export markets, which dampen domestic tobacco production prospects.
- **Marketing quotas.** The reason for quotas at all and how to assign quotas from nongrowers to actual growers. Whether a purchase retirement program for quotas is needed and if so, how much should be paid for such retirement and who are legitimate claimants? Beyond quota owners, who should receive assistance because of declining tobacco production?

- **Program administration.** Whether tobacco growers should be singled out from other crop growers to continue to bear the costs of operating their program, whether all costs that specifically benefit the growing of tobacco, including administrative costs and crop insurance subsidies, should be paid by growers and purchasers, or if all U.S. Department of Agriculture (USDA) tobacco activities should be paid from tobacco tax revenues.
- **Inventory costs.** The high costs of holding surplus tobacco stocks and moving them into trade channels at competitive prices.

Tobacco is the sixth leading field crop produced in the United States, accounting for about 3.5 percent of the total farm value of U.S. crops. It is grown on about 124,000 farms. During calendar year 1993, the value of U.S. exports of unmanufactured and manufactured tobacco was \$5.6 billion, and the net trade surplus was \$4 billion.

Worldwide tobacco consumption outside China is stagnant and new technologies are reducing the amount of tobacco needed per cigarette. Furthermore, a number of countries sharply increased tobacco production in the early 1990's, many with production costs below U.S. levels.

These factors are important considerations in developing and evaluating policies for U.S. tobacco. They are already receiving much attention in connection with appropriations and health care reform debates and will be further examined in the 1995 farm bill debate.